Banxico cuts its reference rate: Additional reductions in the pipeline… For how long?

- Yesterday, Banco de México announced its decision to reduce the reference rate by 50 bps, from 5.50% to 5.00%. The decision was unanimous, a sign that additional rate cuts are in the pipeline.
- The tone of the policy communiqué is neutral. Worth keeping in mind, though, is the fact that the relatively hawkish view regarding inflation's future trajectory presented in the last Inflation Report –presumably– remains.
- Among the most important elements of the policy statement are:

1. The Central Bank continues on guard against events that could trigger a new tightening of external and domestic financial conditions.
2. It claims that the effects of the crisis on growth have been considerable and that uncertainty persists. Accordingly, it foresees greater slack conditions and maintains the balance of risks for growth significantly tilted to the downside.
3. Even though the Bank could have stressed the turning point in both inflation and inflation expectations, it chooses not to do so and acknowledges that inflation's expected trajectory has gone down "slightly" relative to those presented in the last Inflation Report.
4. As for the balance of risks for inflation, uncertainty is the name of the game.

- The policy communiqué did not bring new information in order to answer when the easing cycle will stop. In our current view, a terminal rate of 4.50% is a sound one. However, this assessment is conditional on the evolution of the build-up of domestic risks and to the effects of excess global liquidity on risky asset prices.

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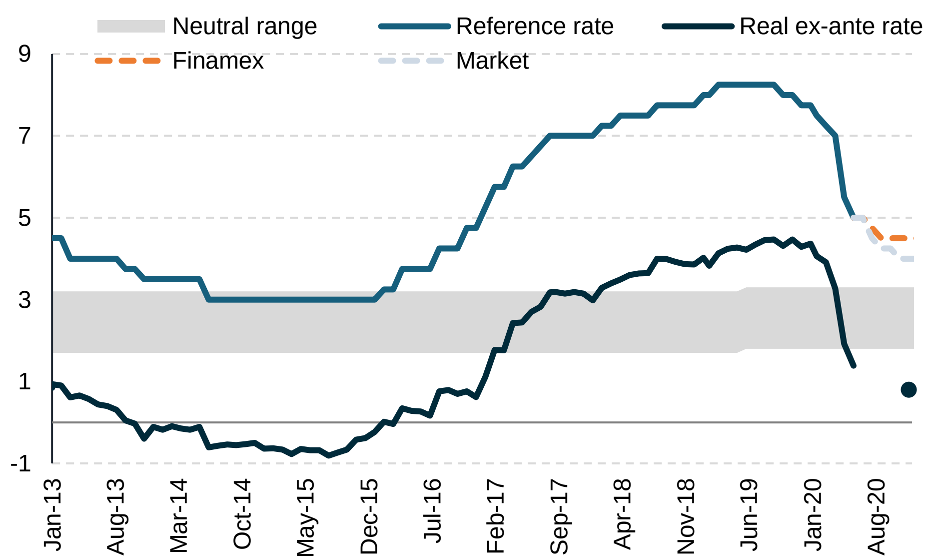
In line with our expectation, yesterday afternoon Banco de México announced its decision to reduce the reference rate by 50 basis points (bps), from 5.50% to 5.00%. With this action, which was also highly anticipated by analysts and markets' consensus, the Central Bank took the ex-ante short-term real interest rate from around 1.8% to 1.4% (see Figure 1). This is, from the lower bound of the latest publicly available estimation for r* –a range between 1.8% and 3.4%– well into easing territory (note: the last time Banxico entered easing territory was in June 2009. It remained there for seven and a half years, until January 2017).

Figure 1. Reference and real ex-ante rates: Observed and expected
(%)



Note: The shadowed area corresponds to Banco de México's latest estimated ranges for r* in the long-term. The end-point of the real ex-ante rate is calculated based on Finamex's projections.
Source: Finamex Economic Research with data from Banco de México and Bloomerg.

As we also expected, the decision was unanimous, a sign that additional rate cuts are in the pipeline (see Table 1).

In our view, the tone of the policy communiqué is neutral. In this sense, the Bank crafted a balanced rhetoric around the gloomy global economic environment (although acknowledging some recent progress), improved external financial conditions, and a dire domestic outlook, in which heightened uncertainty regarding the evolution of the financial shock that the economy faces –and that has triggered external financing restrictions and capital outflows, the steepening of the yield curve, higher risk premium and the currency depreciation– poses challenges for the conduct of monetary policy. Worth keeping in mind, though, is the fact that the relatively hawkish messages conveyed in the last Inflation Report, in particular, that related to the deterioration of expected inflation dynamics amid an unprecedented contraction in growth prospects, –presumably– remain.

Table 1. Banco de México's Board Members Decisions and Dissents

Decision's date	Previous reference rate	Current reference rate	Movement in the reference rate	Quorum	Unanimous decision?	No. of dissenting votes on: Decision	No. of dissenting votes on: Comuniqué's tone
Aug 15, 2019	8.25%	8.00%	-25		No	1 (0 bp)	-
Sep 26, 2019	8.00%	7.75%	-25		No	2 (-50 bp)	-
Nov14, 2019	7.75%	7.50%	-25		No	2 (-50 bp)	-
Dec 19, 2019	7.50%	7.25%	-25		No	1 (-50 bp)	-
Feb 13, 2020	7.25%	7.00%	-25	5	Yes	-	-
Mar 20, 2020 *	7.00%	6.50%	-50	5	No	1 (-25 bp)	-
Apr 21, 2020 *	6.50%	6.00%	-50	5	Yes	-	-
May 14, 2020	6.00%	5.50%	-50	5	Yes	-	-
Jun 25, 2020	**5.50%**	**5.00%**	**-50**	**5**	**Yes**	**-**	**-**

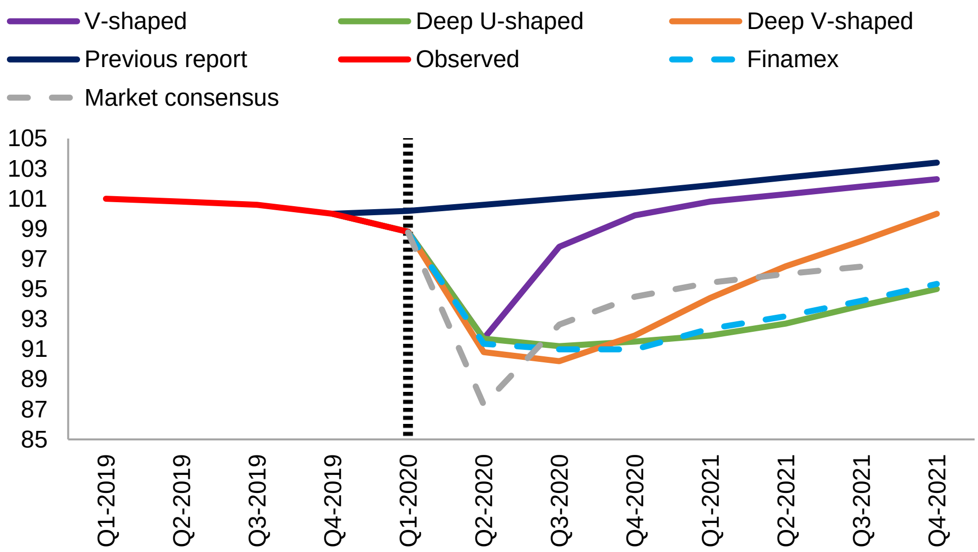
Note: (*) March 20th decision was advanced from its original date (March 26th) and April 21st decision was an out-of-calendar one.
Source: Finamex Economic Research with data from Banco de México.

In our view, the most important elements of the policy statement are the following:

1. The Central Bank continues on guard against events that could trigger a new tightening of external and domestic financial conditions, especially due the effects of the COVID-19 pandemic, which could exacerbate the financial shock upon the Mexican economy.

2. It expects that, after an important contraction during Q1-2020 and a further deterioration in April, domestic economic activity shows certain improvement in May and June amid the reopening of activities in some industries and regions. Nonetheless, it claims that the effects of the crisis on growth have been considerable and that uncertainty persists. Accordingly, it foresees *greater* slack conditions and maintains the balance of risks for growth significantly tilted to the downside (see Figure 2 for the current set of Banxico's projections).

Figure 2. GDP scenarios: Banxico vs. Finamex and consensus (%)



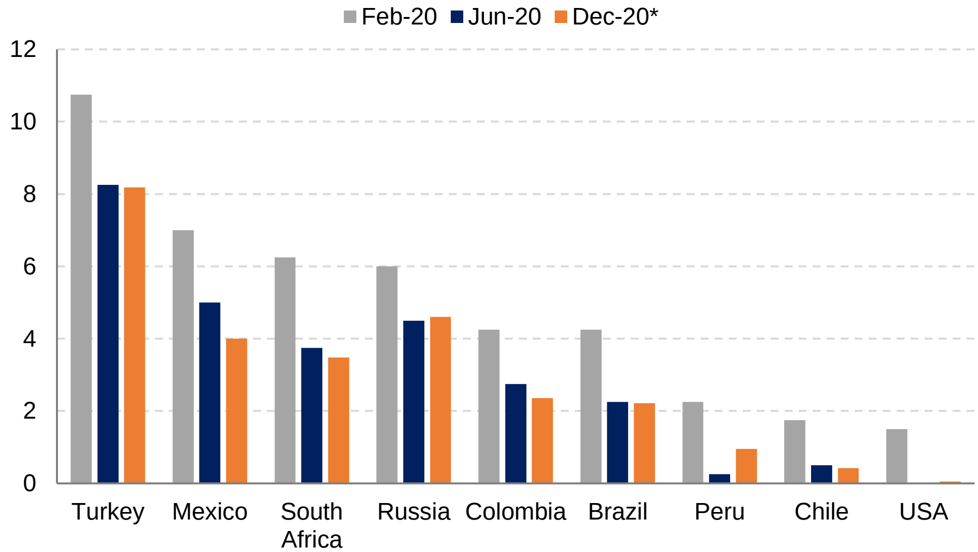
Source: Finamex Economic Research with data from Banco de México and Bloomerg.

3. It points out that inflation has gone up due to the increase in both core and non-core components, and that short-term inflation expectations are still close to 3%, while long-term ones are stable but above target. A key thing here is that even though the Bank could have stressed the turning point in both inflation and inflation expectations, it chooses not to do so. Moreover, it acknowledged that inflation's expected trajectory has gone down slightly relative to those presented in the last Inflation Report.

4. As for the balance of risks for inflation, uncertainty is the name of the game. Additional FX depreciation episodes and "logistical and supply-related problems concerning certain goods and services, as well as cost-related pressures associated with the adoption of sanitary measures" are the main upwards risks, while greater than expected disinflationary effects of a negative output gap and global disinflationary pressures stand among the main downward risks.

Importantly, the policy communiqué did not bring new information in order to answer what we all wonder: when the easing cycle will stop. At the present time, markets point to a terminal rate of 4.00%, on the one hand. One of the arguments that supports this view has to do with the still restrictive relative monetary policy stance vis-à-vis other emerging market economies (see Figure 3). On the other hand, latest analysts' consensus, place the terminal rate at 4.50%.

Figure 3. Reference rates in selected EMEs and the US
(%)



Note: (*) denotes markets' expectation.
Source: Finamex Economic Research with data from Bloomberg.

We will have to wait for the Minutes corresponding to this policy meeting, due on July 9th, to distinguish if any significant changes in Board member's positions reveal more information on the latter point. For the time being, we continue assessing that current economic and financial conditions warrant additional rate cut(s) for up to 50 bps, so that the reference rate reaches 4.50% –which in combination with our inflation expectations for 2021 implies a real ex-ante short-term interest rate of around 0.80%. However, this view is conditional on the evolution of two contrasting forces:

i) The build-up of domestic risks, particularly, those associated with the country's fiscal position and its further weakening due to unconditional government support to Pemex, the detrimental effects of the lack of substantial fiscal stimulus on the shape of the economic recovery, and the consequences of the pervasive erosion of business confidence on potential output.

ii) The effects of excess liquidity prompted by über-accommodative monetary policy in advanced economies, that could trigger downward shifts in global r* and, thus –like in the aftermath of the global financial crisis–, increase risk appetite and search-for-yield strategies that favor domestic assets and contribute to a significant ease in domestic financial conditions.

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